

Should Contractors Stock?

by Richard Harshaw

Lodestar Consulting Systems, Inc.

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A Simple Test

Is stocking equipment a good move for you?

That depends. Do you have adequate inventory levels? To find out, you can compute two simple ratios and then compute a ratio of these two ratios.

Begin by computing your **current ratio**. Go to your last three year-end balance sheets and find the total *current assets* on each one. Then find the total *current liabilities*. Divide each current asset figure by its corresponding current liability figure. Average the three results. This is your **current ratio**.

As a rule, it should be at least 1.50, and strong firms run 2.0 and higher¹.

The next step is to find the total *inventory* on each of those balance sheets. Subtract it from each corresponding *current asset* figure, then divide those results by their corresponding *current liabilities*. Average the results. This is your **quick ratio**.

¹ The use of three year-end balance sheets is only a starting point. I suggest you make as many measures as possible and average the results. Year-end balance sheets are often not typical of the business during other times of the year. A really accurate calculation would take the average current ratio for every month over the last 3 years— 36 calculations, plus the average of the averages.

It should be at least 0.67, and in strong firms it runs 1.50 and up.

The third step is to divide the average current ratio by the average quick ratio. The result should lie *between 1.50 and 2.00*— no higher, no lower². If your ratio is above 2.00, it is probably because you have too *much* inventory. If it is below 1.50, it is probably because you don't have *enough* inventory.

How Can I Tell?

Too much inventory can be harmful. It won't necessarily result in missed sales (unless you have the wrong product mix in stock), but it will tie up precious cash and can be a major cause of poor cash flow.

But not enough inventory can result in lost sales, and no one likes to lose sales!

If your ratio of ratios is below 1.50, check with your sales staff to see if you are losing a significant number of sales (significant being 10% or more of your leads) due to stock-outs. If you do, you could stand to bring in more inventory (based, of course, on the season and your market's usual product mix).

² For the typical contractor, this represents between 6 and 8 inventory turns per year, a target most experts believe is healthy.

If your ratio is below 1.50 and you are *not* losing a significant amount of sales, you may be safe provided your distributor is well-stocked and close enough to get your order to you the same day.

Through Hill and Dale

By the way, it is normal for your current and quick ratios to float up and down as the year progresses because your inventory levels will tend to float with the season's volume. This is why you should analyze several balance sheets, not just the year-end ones. This way you can spot a trend, or see if the average is where it should be.

A Common Misconception

Your ratios will also float around if you do stock orders (either pre-season or monthly) with a bank or a manufacturer's financing division. Many contractors are under the mistaken notion that a financed stock order does not go on their balance sheets. "After all," they say, "it's not mine until I pay the auditor for it." Not so! The financial house only owns the "paper" on your inventory—your promise to repay. *You* own the title to the inventory. Most stock orders are shipped "FOB Shipping Point". This indicates the point at which the title to the merchandise changes hands (in this case, the shipping point, or the distributor's dock). It has nothing to do with "free freight".

The invoice value of the shipment goes on your balance sheet under inventory, with the offsetting liability being Floor Plan Payable. (This is under current liabilities.) Even though these entries

don't change the balance of the balance sheet, they do change the ratios! Consider this example of a balance sheet with and without a floor plan on it:

Without Inventory On "The Books"

Cash	\$30,000	Accounts Payable	\$20,000
Accts Recv	\$80,000	Notes Payable	\$10,000
Inventory	\$30,000	Current Liabilities	\$30,000
Current Assets	\$140,000	Long Term Liabilities	\$30,000
Fixed Assets	\$30,000	Equity	\$110,000
Total Assets	\$170,000	Total Liab and Equity	\$170,000

With Inventory On "The Books"

Cash	\$30,000	Accts Pay	\$20,000
Accts Recv	\$80,000	Accts Pay—Floor Plan	\$50,000
Inventory	\$80,000	Notes Payable	\$10,000
Current Assets	\$190,000	Current Liabilities	\$80,000
Fixed Assets	\$30,000	Long Term Liabilities	\$30,000
Total Assets	\$220,000	Equity	\$110,000
		Total Liab and Equity	\$220,000

The Ratios

	Current	Quick	Current to Quick
Without Floor Plan	4.67	3.67	1.27
With Floor Plan	2.38	1.38	1.72

As you can see, the balance sheet still balances (and I did not touch equity) but the ratios are much different!

Pick Up or Ship Out?

For the balance of this article, let's assume that your current to quick ratio is below 1.50 and that you have determined that this is hobbling sales.

Question No.1— Shall we just run by the distributor's day by day as needed and pick it up, or put in monthly stock orders?

To answer that, let's make a few assumptions:

- (1) It costs \$1.00 a mile to drive your delivery truck, not counting the driver's wages
- (2) The driver makes \$15.00 an hour
- (3) You make an average of 3 trips a week to pick up equipment

Now let's compute the cost of these pick ups and assuming your shop is (a) 10 miles from your distributor's and (b) 120 miles away.

	10 Miles	120 Miles
1. Truck costs, round trip	\$60.00	\$720.00
2. Driver time	40 min	4 hr
3. Warehouse waiting/loading time, "shop talk"	30 min	30 min
4. Total driver time	1 hr 10 min	4 hr 30 min
5. Driver's wage	\$17.50	\$67.50
6. Driver's fringes (average)	\$5.83	\$22.50
7. Total cost per pick up	\$83.33	\$810.00
8. Annual cost (150 trips a year)	\$4,333.16	\$42,120.00

Surprising, isn't it!

Now suppose you did monthly stocking orders. Your orders would be, on average, for 3 units a week, 12 units a month— say, about \$8,000 a month. Freight costs, in most cases, would be prepaid and allowed since most distribu-

tors pay the freight costs on shipments of 6 or more units. And if you set aside the cost of the financed equipment on every job you sell, you'll have the necessary funds when the auditor makes his or her monthly visit and asks for the sold inventory check. What are your costs? Zip. What do you save? In this case, between \$4,300 and \$42,000+ a year. To say nothing of the loss of job-site production of the driver...

The Ginsu Knife Special

But like those Ginsu knife commercials on TV, "But wait! There's more!"

When you pick up units on a daily or weekly basis, they are sold to you on "open account" — which means they go on that month's billing cycle and become due when you receive the invoice from your distributor. Depending on when you pick up the units, you could have anywhere from 10 to 40 days use of the inventory before it is due (assuming billing that is due on the 10th prox). If you sell the unit(s) before then, and deposit the cash to cover the equipment costs to a bank account, you'll have the funds needed to pay the bill when it comes due. If your distributor offers terms, like 2%/10 net 30, you could even pay the invoice on the 10th, earn the 2% discount (amounting to \$160 a month in this case), and end up earning 36% interest (the equivalent of a 2%/10 discount).

But what if the equipment doesn't get installed as planned, or the customer changes the job design, or even fires you? That could hurt you if the bill

comes due and there's no cash to cover it. Do you let the account "ride" and run the risk of going into a COD status with the distributor and weakening your credit rating? Do you scrape and scramble to try to find the cash to stay current?

Another major factor is that when you buy on open account, the purchase goes against your distributor's credit limit for your account. What if you push your status to within a few thousand dollars of your limit and a nice fast-track commercial or custom residential job comes along? Purchasing the equipment for the job may push you over the credit line and hobble your purchasing ability with your distributor.

You avoid all these problems with inventory planning and financing.

Question No. 2: If floor planning can save you money, how do you know how much to order and when?

The accounting programs used by most distributors allow them to generate reports that show exactly what equipment you purchased last year, how much of it you bought, and exactly when you bought it. Your territory manager (TM) can review this report with you and help you set realistic order quantities and trigger dates.

For instance, when I was a TM, I used a report like this to show my contractors what they bought during the months covered by the pre-season plans (4 months). If they had the physical room,

I'd suggest an order of 60% of that list. At first, some of them were apprehensive at the size of the order and worried that it might not all sell by the due date on the floor plan. But when I asked, "Do you mean to tell me that you're planning this year on doing less than 60% of what you did last year?" they began to see my point. If historically you sold 90 condensing units between February and June, don't you think you could sell 54 of them during the same time this year?

When you added the other benefits our company provided for large pre-season orders (things like free freight, bonus incentive trip points, bonus advertising co-op, free or deeply discounted electronic air cleaners and humidifiers, and credit on unsold floor-plan current inventory that was returned if an equal value of product for the upcoming season was purchased), using financing for pre-season orders became a no-brainer.

Real-Life Example

And what about *monthly* stock orders? I'll never forget the experience of a contractor I called on— Charlie, from Columbia, Missouri. Charlie is deceased now, but he used to send a truck to Kansas City (125 miles away) at least once a week to pick up inventory. When I showed Charlie the savings monthly stock orders could generate, he began putting in monthly orders— tentatively at first, then larger and larger ones. Charlie also set up a new savings account at the bank and as units were sold, place cash in that savings account to cover that unit. When the auditor

came by, Charlie always had the money waiting.

A number of things came out of this. I had estimated Charlie's savings to be \$10,000 a year. He actually ended up saving over \$12,000. His account status went from being frequently strained to being a strong open account. And when Charlie saw these impacts on his business, and that he would have had to sell \$150,000 of work to generate the same amount of profit as he was saving, he

just laughed at me and said, "Heck, I only wish I'd a done this sooner!"

Bravo, Charlie! Bravo!

For more information on Lodestar Consulting Systems or my seminars, check my web page (www.lodestarconsultinginc.com) or check with your distributor, or write me at lodestar51@cox.net.